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IN THE

Supreme Court of the United States

OCTOBER TERM—1941

No. ~~1233~~ 89

PALOMA ESTATES, INC., PETITIONER,

—*v.*—

SERIES C-2 TRUSTEES and SECURITIES AND EXCHANGE COMMISSION.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR SERIES C-2 TRUSTEES IN OPPOSITION

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EUGENE J. MORRIS,
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No.

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Opinions Below.

The opinion of the District Court (R. pp. 79-83) is unreported. The opinion of the Circuit Court of Appeals (R. pp. 97-102) is reported in 126 Fed. (2d) 72.

Jurisdiction.

The decree of the Circuit Court of Appeals was entered February 21, 1942. The petition for writ of certiorari was filed May 12, 1942. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

The District Court and Circuit Court of Appeals concurrently determined upon substantial evidence that prior proceedings were pending in the state court and that the interests of stockholders and creditors would be there best subserved pursuant to Section 146(4) of the Bankruptcy Act. (R. 82, 100). The question presented is whether these determinations of fact shall be reviewed by this Court on the basis of the petitioner's unsupported statement that no showing was made that the interests of the debtor's creditors and stockholders would be better safeguarded in the state court.

Statute Involved.

Section 141 of the Bankruptcy Act (11 U. S. C., Sec. 541) provides as follows:

> Upon the filing of a petition by a debtor, the Judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this Chapter and has been filed in good faith, or dismissing it if not so satisfied.

Section 146 of the Bankruptcy Act (11 U. S. C., Sec. 546) provides, in part, as follows:

> Without limiting the generality of the meaning of the term "good faith", a petition shall be deemed not to be filed in good faith if—* * * (4) a prior proceeding is pending in any Court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding.

Statement.

The relevant facts are set forth in the majority opinion of the Circuit Court of Appeals (R. 97-100) and need not be repeated here.

Argument.

1. This case does not involve any conflict between decisions of courts.

2. The concurrent determinations of fact of the courts below, unless shown to be plainly erroneous, require a denial of the application for certiorari.[1]

The determinations of fact of the lower courts were not clearly erroneous. On the contrary, they are supported by overwhelming proof.

The existence of prior proceedings in the state court has never been seriously questioned. Even the dissenting opinion in this case assumes the existence of such prior proceedings (R. 101-102). There is pending in the state court a dominant plan of reorganization covering all of the 102 securities of Series C-2, including the instant mortgage (R. 20-26).[2] As part of this dominant plan, the debtor's

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1 *United States* v. *Chemical Foundation*, 272 U. S. 1; *Alabama* v. *Ickes*, 302 U. S. 464; *Page* v. *Arkansas Gas Corporation*, 286 U. S. 548; *United States* v. *Commercial Credit Co.*, 286 U. S. 63; *General Talking Pictures Corporation* v. *Western Electric Company, Inc.*, 304 U. S. 175. The determination of the District Court should not be disturbed unless it constitutes an abuse of discretion. The widest discretionary power in approving or dismissing a petition under Section 146 is vested in the District Court. The Federal Appellate Courts have diligently preserved this discretion by refusing to reverse unless a clear abuse of discretion has been shown. *Tennessee Publishing Co.* v. *American National Bank*, 299 U. S. 18; *Wayne U. G. Co.* v. *Owens-Illinois*, 91 Fed. (2d) 827.

2 This plan was promulgated under the so-called Schackno Act. (Chapter 745 of the laws of 1933 of the State of New York as amended, N. Y. Unconsolidated Laws, Sec. 1796, *et seq.*)

interests were reorganized in two independent proceedings in the state court. In the first proceeding, which was sponsored by the debtor, the mortgage was extended and modified (R. 38-40). The debtor defaulted under its terms but it was a subsisting agreement at the time the Chapter X proceeding was initiated (R. 39, 45). The second proceeding sponsored by the debtor involved a plan to purchase the mortgage at a price approved by the debtor (R. 40-46). The state court order approving this plan likewise was in full force and effect at the time the Chapter X proceeding was initiated, although the debtor refused to perform thereunder (R. 45). The default of the debtor in both of these proceedings did not affect the continuance of the dominant, pending plan of reorganization to liquidate the investment of certificate holders. That plan is to acquire title to the property and to manage it efficiently and economically pending the speediest possible sale at a fair price (R. 48, 54). No other plan can be sound or necessary.

Under said plan, a foreclosure action has so far progressed that judgment of foreclosure and sale has been entered.[3] Title to the property may be acquired by the certificate holders in this action without further expenses and delay through a purely formal and ministerial Referee's Sale. This last step in the foreclosure action has been stayed in order to enable the debtor to make an application for a stay to this Court.[3]

The ultimate facts, drawn from the extensive proof in

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3 The foreclosure action was commenced after the initiation of the Chapter X proceeding. The Circuit Court of Appeals denied an application for a stay by order dated March 18th, 1942 as follows:

> "ORDERED, that said motion be and hereby is denied, except that in case the day of sale occurs before the application for a writ of certiorari is granted, any sale will be stayed until the Supreme Court of the United States has passed upon that, and for five days thereafter so that applicant can apply to a Justice of the Supreme Court for a further stay."

the record, which support the determinations of the courts below are substantially as follows:

(a) The proceeding in the state court is peculiarly designed for and adapted to the administration and liquidation of a group issue of guaranteed certificated mortgages (R. 20-26, 28, Ex. B).

(b) The disassociation of 200 West 86th Street from the other properties in the group series (which will remain in the state court) must result in duplication of expense, delay, confusion and the creation of insuperable problems and difficulties of administration and liquidation (R. 53-57).[4]

(c) The supervising Supreme Court Justice, the Trustees, and the personnel of their office are eminently qualified by background and experience to complete successfully the pending reorganization (R. 27-32).

(d) The actual experience under this plan of reorganization, both as to the group series and as to the instant property, indicates sound, efficient, and economic administration of the liquidation process (R. 32).

(e) The reorganization as to the instant property has so far proceeded that no useful purpose would be served by a change in forums.[5]

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4 It should be noted that the interest of each certificate holder of Series C-2 cannot be allocated to any one property, since each certificate represents an undivided interest in all of the 102 properties of the Trust Estate.

5 The Securities and Exchange Commission has recognized that the status of the state court proceeding is an important factor as appears from the following quotation from its brief in the *Marine Properties* case. "The mere pendency of prior state court proceedings is immaterial; they must be of such a character or have proceeded to such a point that the security holders would be harmed rather than helped by calling the remedial provisions of Chapter X into play".

(f) The safeguards in the state court reorganization are substantially equivalent to those contained in Chapter X (Declaration of Trust, Ex. B). In certain important aspects, safeguards which were specifically designed for this type of a reorganization are superior to those of Chapter X (Declaration of Trust, Ex. B, Articles VIII, XIV).

(g) There has been no adverse criticism of any aspect of the state court proceedings.

The dissenting opinion does not question any of these facts which support the determination of the majority court. The dissenting judge did not decide that the debtor's petition should be approved, but merely that the proof, which was in affidavit form, was insufficient for that reason (R. 102).[6] There is no provision in the law applicable to Chapter X which disqualifies proof taken by the District Judge in affidavit form. In any event, the criticism of the form of the evidence cannot be a basis for the granting of certiorari.[7]

3. The Solicitor General, representing the Securities and Exchange Commission, has determined not to sponsor the debtor's petition for certiorari. The Securities and Exchange Commission sponsored the debtor's petition under Chapter X prior to the determination of the Circuit Court of Appeals. This sponsorship was apparently motivated by the belief of the Securities and Exchange Commission that the district court, in dismissing the debtor's petition, relied unduly upon the authority of *In Re Blinrig Realty Corp.*,[8]

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6 The fact is, however, that extensive oral hearings were held before the District Court.

7 *United States* v. *Johnson*, 268 U. S. 220; *Southern Power Company* v. *North Carolina Public Service Company*, 263 U. S. 508; *Houston Oil Company of Texas* v. *Goodrich*, 245 U. S. 440.

8 *In Re Blinrig Realty Corp.*, 114 Fed. (2d) 200.

and *Brooklyn Trust Company* v. *Rembaugh*.[9] These cases had been sharply criticised by the Securities and Exchange Commission. The decision of the court below did not find the doctrine of these cases to be either relevant or necessary to a determination of the instant case. On the contrary, it squarely determined that the proof justified a determination that good faith was lacking under Section 146(4). The possibility that the doctrine of the *Blinrig* and *Rembaugh* cases would be perpetuated in the instant case (which presumably was the reason for the sponsorship of the debtor's petition by the Securities and Exchange Commission in the Circuit Court) no longer exists.

The Solicitor General representing the Securities and Exchange Commission did, however, sponsor certiorari in *Marine Harbor Properties, Inc.* v. *Manufacturers Trust Company*[10] in which certiorari was recently granted. That case affirmed and clarified the doctrine of the *Blinrig* and *Rembaugh* cases. It held, in effect, that the debtor's petition must be dismissed because of a personal disqualification of the debtor flowing from its participation in prior state court proceedings. The gist of the criticism of these cases by the Securities and Exchange Commission[11] and as contained in Judge Frank's dissenting opinion in the *Marine Harbor* case is that these cases do not consider whether the interests of stockholders and creditors would be best subserved in the state court. The effect of this, it is urged, would be to preclude the District Court from continuing a Chapter X proceeding for the benefit of parties other than the debtor.

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9 *Brooklyn Trust Company* v. *Rembaugh*, 110 Fed. (2d) 838.

10 *Marine Harbor Properties, Inc.* v. *Manufacturers Trust Company*, 125 Fed. (2d) 292 (certiorari granted March 16, 1942).

11 See brief of Solicitor General representing the Securities and Exchange Commission submitted in support of certiorari in the *Marine Harbor Properties* case.

The doctrine of these cases and the criticisms thereof simply have no relevance to the instant case.

The mere existence of prior proceedings in the state court was not the basis for the Court's determination in the instant case, nor was there involved the doctrine of personal disqualification which presumably flows from such participation. On the contrary, both lower Courts made specific determinations upon substantial evidence that the interests of creditors and stockholders would be best subserved in the prior proceedings under Section 146 (4). This Section was not at all involved in the *Rembaugh, Blinrig* or *Marine Properties* cases and in the latter case, the Court there expressly disclaimed the applicability of Section 146(4) to the facts therein.[12]

The instant case was decided after the *Rembaugh, Blinrig* and *Marine Harbor* cases. These cases were neither cited, nor relied upon, by the majority Court.

The dissenting opinion in the instant case criticises the doctrine in the *Rembaugh, Blinrig* and *Marine Harbor* cases for the apparent purpose of enabling Judge Clarke to express his disagreement with those determinations. He did not attempt to relate the doctrine of these cases to the facts of the instant case. His factual determination was that the case should be reversed for a more searching inquiry on the facts. There is implicit in such determination the conclusion that if the proof were sufficient, the determination of the majority Court was proper.

4. The debtor's petition for certiorari is almost exclusively a discussion of the issues of the *Marine Harbor* case

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12 In the *Marine* case, the court said:

> "Section 146 (11 U. S. C. A. Par. 546) expressly disclaimed any limitation upon the generality of the meaning of good faith and Subdivision (4) of that Section is but one special instance of what will show a disabling absence of it on the part of a debtor and is not to be confused with what controls here."

and its language and content is largely culled from the brief of the Securities and Exchange Commission submitted in support of certiorari in that case. The petition evidences either a misapprehension of the issues in this case, or a deliberate effort to bind this case to one which involves completely different considerations. The petition, in presenting the question involved in this case, has repeated the exact language of the question presented in the brief (at p. 3) of the Solicitor General in support of certiorari in the *Marine Harbor* case. The question assumes that the mere existence of prior proceedings without more, resulted in the concurrent determinations in the instant case. This assumption is at utter variance with the facts. There is subsequently superimposed upon this basically erroneous assumption the equally erroneous assumptions that the doctrine of personal disqualification is involved in this case and that the prior proceedings were the Schackno and Mortgage Commission Acts. The resultant discussion is necessarily a melange of patently irrelevant statements and conclusions.

CONCLUSION.

The petition for certiorari should be denied.

Respectfully submitted,

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PALOMA ESTATES, INC.,

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SERIES C-2 TRUSTEES

and

SECURITIES AND EXCHANGE COMMISSION.

SUPPLEMENTAL MEMORANDUM IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Statement.

In an application dated November 17th, 1942, your petitioner, Paloma Estates, Inc., the debtor herein, sought leave of this Court to submit a memorandum supplemental to that embodied in the pending petition for writ of certiorari. The express purpose was to set forth the significant distinctions between the issues raised in these proceedings and those raised in *Marine Harbor Properties, Inc., Petitioner,* v. *Manufacturers Trust Company* on writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit. Those distinctions

were highlighted in the opinion of this Court rendered in the *Marine Harbor* case on November 9th, 1942.

Leave to submit this supplemental memorandum was granted on November 18th, 1942.

Argument.

A. In the *Marine Harbor* case, the debtor filed a voluntary petition under Chapter X and thereafter obtained an ex parte order approving the petition and appointing trustees. No answer to the petition had been filed. Shortly thereafter the mortgage trustee moved to vacate that order and to dismiss debtor's petition on the ground that it was not filed in good faith. That motion was denied and an appeal taken to the Circuit Court, which generated further proceedings in the Supreme Court of the United States, culminating in the opinion of Mr. Justice Douglas on November 9th, 1942.

In the instant case the proceedings of the District Court included the filing of petition (R. 2) and supporting affidavits (R. 6, 58) and an answer (R. 9) and affidavits in support of the answer to the petition (R. 19). No hearing was provided by Mr. Justice Knox at which evidence could be offered to resolve the legal and factual issues thus raised.

Whether or not the failure to afford a hearing at which evidence could be adduced in the Marine Harbor proceedings may not have contravened the provisions of the Bankruptcy Act, the joining of issue through the interposition of an answer supported by affidavits in the District Court proceedings of the instant case made a trial of the issues mandatory. That was the law under former Section 77B carried over into Section 144 of the present Bankruptcy Act. Section 144 reads as follows:

> "If an answer filed by any creditor, indenture trustee, or stockholder shall controvert any of the instant alle-

> gations of the petition, the judge shall, as soon as may be, determine, without the intervention of a jury, the issues presented by the pleadings and enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith and that the material allegations are sustained by the proofs, or dismissing it if not so satisfied."

Application of the hearing provision had been made in *In Re Cheney Bros.*, 12 F. Supp. 609 (D. C. D. Conn. 1935), p. ~~601~~ 611, where the court held:

> "If such denials of material facts in the petition are properly made, then it becomes the duty of the court to hold a summary hearing thereon, at which hearing the duty devolves upon the debtor to sustain the material allegations of its petition by proof."

Notwithstanding the foregoing requirement of a hearing, the District Court below made its determination solely on the basis of the petition, answer and affidavits. No opportunity was afforded petitioner to introduce evidence at a hearing which would demonstrate that it was entitled to relief under Chapter X which, petitioner alleged, could alone serve the best interests of creditors and stockholders (R. 5).

In dispensing with the hearing clearly called for by Section 144 of the Bankruptcy Act, Mr. Justice Knox relied on, and was misguided by, the then existing law in the United States Circuit Court of Appeals for the Second Circuit, subsequently overruled by the opinion of this court in the *Marine Harbor* case wherein this Court asserted that the test laid down in the *Brooklyn Trust Co.* v. *Rembaugh*, 110 F. 2d 838, was not the test of "good faith" which Congress had provided in Section 146 (4). The

Circuit Court of Appeals in the *Rembaugh* case had held, as a matter of law, that the debtor's petition was not filed in "good faith" since it had previously voluntarily submitted itself to the jurisdiction of the State Court. That was the basis of Judge Knox' opinion in the District Court expressly made to rest on the *Rembaugh* case. Judge Knox, having been satisfied from the affidavits that the debtor had been involved in Schackno Act proceedings, determined, as a matter of law, that the petition before him was *ipso facto* filed in bad faith and that petitioner was thereby barred from Chapter X proceedings.

The majority of the Circuit Court affirmed Judge Knox' opinion employing the same test enunciated in the *Rembaugh* case. Mr. Justice Clark dissented on the ground, among others, that the test laid down in the *Rembaugh* case and followed by Mr. Justice Knox and the majority of the Circuit Court, was inadequate. His view was that there should be an opportunity to adduce evidence to show whether the interests of creditors and stockholders would be better subserved in the State Court proceedings than in proceedings under Chapter X of the Bankruptcy Act. Said he:

> "The stress placed here upon the district judge's finding seems to me not to dispose of the problem. He made no investigation; he had before him only the affidavits now before us. And his finding is most general, merely that the trustees' defenses, formally pleaded, 'are sufficient in law and sustained by the proof.' Moreover, his opinion shows that he relied on our previous decisions, and was unduly concerned—as I believe we have been—in the activities of the debtor and how it may have estopped itself. This, I believe, was the initial error in *Brooklyn Trust Co.* v. *Rembaugh, supra,* since repeated

in the other decisions. For the statute here pertinent, authorizing dismissal of the reorganization petition when it appears 'that the interests of creditors and stockholders would be best subserved' in the prior state proceeding, Bankruptcy Act, §146 (4), 11 U. S. C. A. §546 (4), requires a definite finding as to the interests of *creditors and stockholders*, not of the debtor. I think we should limit our former precedents to make it clear that the judge must conduct the investigation thus so clearly required (wherein, too, the assistance of the Securities and Exchange Commission could be sought and might well prove valuable), and that we should take the first step thereto in a case such as this, where the facts already disclosed seem to call so clearly for a more searching inquiry. I would reverse for a hearing on the facts" (R. 102).

That view has apparently been sustained by this Court in the *Marine Harbor* case wherein the Rembaugh test was expressly overruled. The basis for Judge Knox's decision, and of the affirmance by the majority of the Circuit Court below, has thus been destroyed.

Since the question of law on which Judge Knox relied in dispensing with a hearing was erroneous, petitioner is now entitled to proceed with the usual trial of the issues presented by the pleadings. That opportunity will be denied to petitioner in the circumstances of this case unless this Court grants a review.

B. The decisive factor which dictated this Court's decision in the *Marine Harbor* case was the pendency in the State Court, prior to the initiation of Chapter X proceedings, of a foreclosure action instituted by the trustee. In view of the pendency of that prior State Court proceeding, it was held that petitioner was obliged to "demon-

strate that at least in some substantial particular the prior proceedings withhold or deny creditors or stockholders benefits, advantages, or protection which Chapter X affords. In absence of such a showing the 'need for relief' has not been established and the District Court is not enabled to make an informed judgment on the 'good faith' issue."

In the instant case no foreclosure proceedings were pending prior to the filing of the debtor's petition in the bankruptcy court (R. 81). Accordingly it was not incumbent upon the debtor herein to advance the type of evidence called for under that circumstance of the *Marine Harbor* case. The burden on petitioner, in the absence of a prior pending proceeding such as foreclosure, is the same as that imposed on any debtor, irrespective of involvement under the Schackno Act, who wants to come into the Federal Courts.

It is noteworthy that in the absence of prior pending proceedings and where petitioner is not otherwise within the prohibitions of Section 146 of the Bankruptcy Act, that the feasibility of any prospective plan of reorganization cannot be prejudged from the mere examination of the petition. The good faith inquiry assumes a somewhat different complexion from that posed by the circumstance of a pending prior proceeding. It has been held in *In re Julius Roehrs Co.*, 115 Fed. 2d 723, CCA 3d (1940)* that in determining whether debtor's petition for reorganization was filed in good faith, the court was not required to ascertain whether a particular plan of reorganization could be carried out, but only whether it was reasonable to expect that a plan could be effected, that there was opportunity and need for reorganization, and

* The Securities and Exchange Commission appeared in this case and urged the position taken by the court.

that the petition was filed with the honest intention of effecting it and not for the purpose of hindering or delaying creditors. It is the duty of the court to ascertain the answer to those questions at a hearing.

It has further been held that a reorganization plan consisting merely of an advantageous liquidation might be feasible and valid as long as the proposed plan provides a fair equivalent for any rights that the creditors have lost. *In re Central Funding Corporation*, 75 Fed. 2d 266 (CCA 2, 1935). The court significantly remarked that:

> "A 'reorganization' does not necessarily presuppose the survival of the rights of stockholders or even of junior creditors, when they have become worthless, but may be a readjustment of the rights of lienors under a new corporate structure. While this has generally been effected through foreclosure sales, such has not always been the method, and section 77B was evidently inserted in the Bankruptcy Act in order, among other things, to facilitate corporate readjustments without the delay, complexity, and difficulty inherent in the cumbersome methods that were formerly regarded as necessary.
>
> "It makes no difference whether the debtor has an equity of any value or not, or whether his business is to continue for five or ten years or indefinitely * * * To restrict the Act (former Section 77B) to where the debtor has an equity, would be to deprive the section of much, if not most, of its usefulness."

In the light of the *Central Funding Corporation* case it cannot be said that a prospective plan on the part of the debtor (R. 5, 70) in the instant case, having as its objective the retirement of the mortgage, might not be desirable and the most salutory course. There is no

material distinction on the question of reorganization between liquidation and retirement of creditors' interests.

It is reiterated that under the circumstances of the instant case petitioner's need for relief is the same as that of any debtor seeking access to the Federal Courts irrespective of that debtor's involvement under the Schackno Act. In this background, in determining the feasibility of reorganization in the bankruptcy court, the safeguards under Chapter X, lacking under the Schackno Act, as set forth in pending petition for certiorari, provide a persuasive argument for allowing debtor access to the Federal Courts. That argument is vigorously and specifically fortified by taking cognizance of the unrestricted and arbitrary veto power of the trustees, acting under the sanction of the Schackno Act, which caused Judge Clark to remark caustically:

> "* * * the trustees are now acting as dogs in the manger; for they will not present the debtor's revised plan to the state court, and that appears to be the only way it can get there" (R. 101).

His further remarks anent the feasibility of a plan of reorganization involving retirement of the mortgage, merit consideration on this application:

> "Though we cannot be sure without testimony, we can conclude that in the present state of the real estate market, a sale, even at a reduced price, might easily prove to the best interests of all, including the certificate holders. In other words, the matter ought to be before a court for decision, not left solely to the not wholly disinterested trustees" (R. 101).

Conclusion.

This Court in *Marine Harbor Properties, Inc.* v. *Manufacturers Trust Co.* (*supra*) expressly overruled the test of "good faith" established by the Circuit Court in *Brooklyn Trust Co.* v. *Rembaugh,* 110 Fed.[2d] 838, and followed by the courts below in denying the instant debtor recourse to the bankruptcy court. It was error for the District Court and the majority of the Circuit Court to impute bad faith in filing the petition under Chapter X, as a matter of law, because Schackno Act Proceedings were involved. It was further error to determine the issues raised by the petition, answer, and affidavits, without a preliminary trial of those issues as prescribed by Section 144 of the Bankruptcy Act. The absence of prior pending foreclosure proceedings in the instant case obviates, in any event, the necessity of debtor to produce evidence of the type required in the *Marine Harbor* case. Petitioner is bound by the requirements applicable to any debtor seeking access to the Federal Courts, who is not involved in Schackno Act Proceedings.

It is accordingly respectfully submitted, on the basis of this Court's decision in the *Marine Harbor* case, that the determination of the lower courts should ultimately be reversed and at the very least the case remanded for hearing for the purpose of adducing evidence raised by the issues.

Wherefore, your petitioner prays that the petition for a writ of certiorari to the United States Circuit Court of Appeals be granted.

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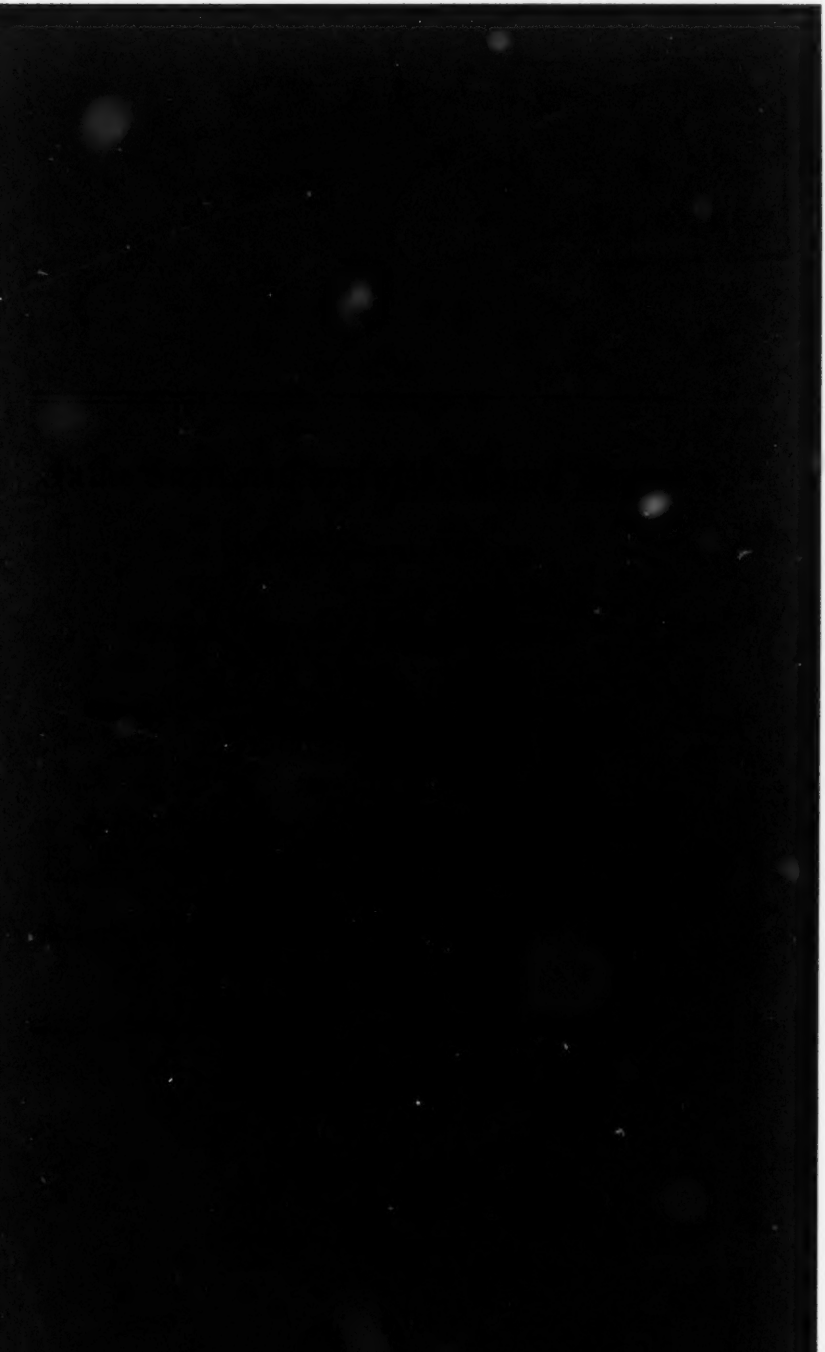

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SERIES C–2 TRUSTEES AND SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

THE COMMISSION'S POSITION

The Securities and Exchange Commission, at the request of the district judge under Section 208 of the Bankruptcy Act (11 U. S. C., Sec. 608), filed a notice of appearance in this proceeding for the reorganization of Paloma Estates, Inc. under Chapter X of the Bankruptcy Act. The Commission also participated as an appellee in the proceedings before the Circuit Court of Appeals, and is named a respondent in the Debtor's

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petition for a writ of certiorari. The Commission urges, in view of the opinion of this Court in *Marine Harbor Properties, Inc.* v. *Manufacturer's Trust Co.* (October Term, 1942, No. 24, decided November 9, 1942), that error was committed by the courts below in dismissing the Debtor's petition under Chapter X. Because of the importance in the administration of the Bankruptcy Act of the problem involved, the Securities and Exchange Commission believes that the writ should be granted.

ARGUMENT

The facts are adequately set forth in the Debtor's petition (pp. 3–5). As in the *Marine Harbor* case there is here involved a real estate property concededly worth less than the first mortgage; there have been proceedings under the Schackno Act (N. Y. Laws of 1933, c. 745) and the Mortgage Commission Act (N. Y. Laws 1935, c. 19) pursuant to which permanent trustees for certificate holders were appointed; there was an agreement for the extension of the maturity of the certificated mortgage, with a reduction in interest; a default occurred in the payment of interest and taxes; and there were fruitless negotiations between the trustees and the Debtor looking to the modification of the extension agreement or to the Debtor's purchase of the mortgage at a discount. Finally, upon threat of foreclosure, the Debtor filed its petition under Chap-

ter X. In this case, unlike the *Marine Harbor* case, no foreclosure was pending when the petition for reorganization was filed;[1] and, as we shall show, there are material factual differences.

The District Court dismissed the petition for lack of good faith under Section 146 (4) of Chapter X. It found as a matter of law that defenses which pleaded in effect the doctrine of *Brooklyn Trust Company* v. *Rembaugh,* 110 F. (2d) 838 (C. C. A. 2), were sufficient, and dismissed upon that ground alone.[2] The court be-

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[1] Foreclosure proceedings were begun *after* the Debtor filed the petition under Chapter X (Br. in Opp., p. 4, note 3).

[2] The District Court stated in its opinion (R. 82):

> For the first separate defense, it is said that the petition was not filed in good faith, for the reason that the bond and mortgage which the debtor seeks to re-organize are in process of reorganization and liquidation pursuant to the provisions of Chapter 745, of the Laws of 1933 of the State of New York, as amended, under the supervision of the Supreme Court of the State of New York. It is further alleged that a plan of reorganization involving a modification and extension of mortgage and a plan of liquidation involving the satisfaction or assignment of said mortgage were approved by the State Court, and consented to by the debtor, and remain in full force and effect.
>
> In paragraph 12 of the answer, [contained in the third defense of the answer] the C-2 trustees tender their specific issue. "That the prior proceedings pending in the Supreme Court of the State of New York will best subserve the interests of creditors and stockholders".
>
> The third separate defense is patterned after the conclusions reached in the Rembaugh and Blinrig cases,

low (Judge Clark dissenting) affirmed upon the ground that the finding of the District Court was warranted by the record. (R. 100–101.) It thus appears that both courts below rested their decision solely on a reason which this Court said in the *Marine Harbor* case "is not the test which Congress has provided in Section 146 (4)."

Since, therefore, the basis of the decisions of the courts below in this case has now been expressly overruled by this Court, there remains the question whether the Debtor has here made the showing which this Court held had not been made in the *Marine Harbor* case—a "need for relief" under Section 130 (7) read in the light of Section 146 (4).

1. The initial element of a showing that a "need for relief" exists is proof that reorganization is required. Such proof appears here from the undisputed allegations that the mortgage is in default, that there is property of substantial value available for the satisfaction of the mortgage debt, and that the property is of such nature that a destruction of values would result from forced liquidation. Under these circumstances, it is apparent that a mechanism is required to vest the property in the security holders under a new security structure.

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and upon the record here made, I think both of the foregoing separate defenses are sufficient in law and sustained by the proof.

2. Chapter X, of course, provides such a mechanism. In so far as the "need for relief" under Chapter X is limited by the availability of an alternative forum for the reorganization, we submit that there is no such forum here. This Court reiterated in the *Marine Harbor* case that the bankruptcy power is paramount; accordingly, the availability of a competing forum must be determined under Sec. 130 (7) in the light of Section 146 (4). Section 146 (4) requires that any competing proceeding be "prior" and "pending", and that it best subserve "the interests of creditors and stockholders". In this case, unlike the *Marine Harbor* case, no foreclosure was pending when the petition was filed. Since the availability and adequacy of the prior pending foreclosure appear to have been the basis of this Court's decision in the *Marine Harbor* case, this factor alone materially differentiates the instant case.

Nor do the proceedings in the state court having jurisdiction over the Schackno Act trust provide such an alternative forum as to show that the Debtor has not proved a "need for relief" under Chapter X.

(a) First, the Schackno proceedings will not best subserve the interests of creditors. In the absence of a foreclosure, the Schackno Act procedure affords no adequate remedy to the certificate holders. These proceedings contain in themselves no means of taking over the property, and

no plan can be effectuated without the consent and cooperation of the debtor. This material limitation of the available coercive procedure would, of course, affect the type of plan that could result.

Even assuming (despite the requirement of Sec. 146 (4) that an alternative proceeding be "prior" and "pending") that the adequacy of the Schackno procedure should be considered in the light of the fact that foreclosure proceedings could be (and were) subsequently instituted, we submit that the two state court procedures together would not best subserve the interests of creditors. Under these proceedings the Series C–2 Trust, upon completion of the foreclosure, would acquire title and the property would continue in the trust. The question whether the property should be continued in that trust, or should be reorganized separately [3] and the new securities distributed to certificate holders, is one on which certificate holders are given no opportunity to pass under the Schackno Act procedure, which leaves the power of decision in trustees, not in the real parties in interest. Under Chapter X, however, the trustees under this type of agreement do not have the exclusive right to vote on plans of reorganization. Cf. *Brooklyn Trust Co.* v. *Rembaugh,* 110 F. (2d) 838 (C. C. A. 2); *In re Castle Beach Apartments, Inc.,* 113 F. (2d) 762 (C. C. A. 2).

[3] Unlike the single mortgage involved in the *Marine Harbor* case, the present mortgage is only one out of 102 mortgages in the "Series C–2" group of certificated mortgages (R. 26–27, 32–33).

And in so holding, those decisions conform to the Congressional intention of "democratization" of corporate reorganizations. See S. Rep. No. 1916 on H. R. 8046, 75th Cong., 3d Sess., p. 22; H. Rep. No. 1409 on H. R. 8046, 75th Cong., 1st Sess., pp. 37–38, 43, 47; cf. the recommendations of the Securities and Exchange Commission in Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part I (1937), p. 901.

Apart from the right of the security holders to have a voice in the disposition of the matters, it is apparent that in this case there may be a substantial conflict of interest between the Series C–2 trustees and their certificate holders. The trustees have an avowed interest in the preservation of their organization (R. 27–32). This interest stands in contrast to the emphasis of Chapter X on the independence of trustees and the speedy return of property to its real owners. See H. Rep. 1409, *supra,* p. 43. And in this and similar cases, it may well be to the best interests of security holders to withdraw particular properties from the group mortgage trusts as speedily as possible. Into the group mortgage series the companies which sold mortgage certificates habitually dumped their worst properties, the ones which were otherwise unsalable.[4] Series C–2, in

[4] Report of George W. Alger to the Governor of New York, dated October 5, 1934, pp. 103–104, 118–123.

keeping with this tendency, was and is secured by a heterogeneous collection of mortgages, including some on vacant lots, large and small garages, and like properties, and practically all of them have been in default at one time or another (R. 17, 27). The Series C–2 certificates, reflecting the character of the collateral, are selling for about 40 cents on the dollar of face amount (R. 44). But the property here in question, which is one of the largest and best in the entire Series C–2 portfolio, appears to be worth about two-thirds of its face amount (R. 32–35). If this property were reorganized separately, the securities representing interest therein plus the remaining value of the trust certificates might well be higher than the value of the trust certificates alone as at present, where the commingling of good and bad properties under a single capital structure may be a depressing influence on the value of all. On these points we express no judgment: the possibilities involved require the use of the expert investigative techniques embodied in the Chapter X procedure, the report to security holders contemplated by Sections 167 and 175 (11 U. S. C., Secs. 567, 575), and an opportunity for security holders to vote on their own destiny.

Considerations of this nature remain applicable even if it be assumed that the trustees are willing to sell the property if a favorable opportunity is offered. Even when a proposal for such a sale is submitted to the state court and notice is given

to the security holders, the value of their opportunity to express their views is lessened by the lack of the investigatory and informatory processes of Chapter X. *Securities and Exchange Commission* v. *United States Realty Improvement Co.*, 310 U. S. 434, 448–450. Moreover, the trustees have shown a desire to use the proceeds of proposed property sales not for equal distribution among certificate holders, but to retire certificates as cheaply as possible (R. 44–45). This pits the certificate holders against each other, a result which requires careful consideration before it should be sanctioned.

Finally, the apparent helplessness of the trustees with respect to diversion of certificate holders' funds, which they themselves assert to exist (R. 36, 47), emphasizes the inadequacy of Schackno Act procedure in contrast to the investigatory processes provided by Chapter X (Sec. 167, 11 U. S. C. Sec. 567).

(b) Second, the Schackno Act proceedings are not "prior proceedings" within the meaning of Sec. 146 (4).[5] As this Court recognized in the *Marine Harbor* case, "Sec. 146 [(4)] represents a codification of some of the interpretations which the courts had given the words 'good faith' in proceedings under § 77B." Congress has, by specific

[5] We advanced these arguments in the *Marine Harbor* case (Br. p. 21). This Court did not pass upon the contentions, but regarded the foreclosure proceedings as the prior pending proceedings.

enumeration elsewhere in Chapter X, attributed to the words "prior proceeding" a connotation similar to that found in the good faith cases under Section 77B. See Sections 113, 131, 148, 256 (11 U. S. C. A. 513, 531, 548, 656). In the concept employed in those cases, the phrase "prior proceeding" had reference only to a proceeding in which the assets of a debtor were in *custodia legis* for the primary purpose of rehabilitation or distribution for the benefit of claimants. See, for example, *In re Wisun & Golub, Inc.,* 84 F. (2d) 1 (C. C. A. 2); *Hickey* v. *The Ritz-Carlton Restaurant & Hotel Co. of Atlantic City,* 96 F. (2d) 748 (C. C. A. 3); *Brockett* v. *Winkle Terra Cotta Co.,* 81 F. (2d) 949 (C. C. A. 8); *Snyder* v. *Fenner,* 101 F. (2d) 736 (C. C. A. 3); *In re Knickerbocker Hotel Co.,* 81 F. (2d) 981 (C. C. A. 7). By this standard the state proceedings are not "prior proceedings" within the meaning of the statute.

(c) Third, the Schackno Act proceedings are not "pending", because they were consummated when the present trust was created. The trust is operating, and no court proceedings are pending with respect thereto. The court reserved jurisdiction to entertain further applications and to approve certain proposed action by the trustee, but no applications or other proceedings are "pending". As we note below, the trustees have refused to institute any proceedings by filing the application requested by the Debtor.

3. As we understand the *Marine Harbor* case, the circumstances recited above which show a "need for relief" to creditors under Chapter X render it unnecessary to make an additional showing of need for relief to stockholders, even though the petition was filed by the Debtor, not by creditors. This conclusion, which is in any event clear from the *Marine Harbor* opinion, is buttressed by the fact that a debtor's petition is not defective merely because the debtor is insolvent. Sections 130 (1), 216 (8) (11 U. S. C. Secs. 530 (1), 616 (8)); *In re Julius Roehrs Co.*, 115 F. (2d) 723 (C. C. A. 3). And a debtor's petition may result in the exclusion of stockholders under the plan. *Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, 131.

Thus a debtor's petition may sometimes be an appropriate vehicle for a reorganization in the interests of creditors.

Although, accordingly, we think that no additional showing is required that there is a "need for relief" for *stockholders* under Chapter X, we think that such a showing is made on the present record. Unlike the record in the *Marine Harbor* case which this Court interpreted as showing a proposal by the Debtor which would result in "a dilution of creditors' interests", the present record discloses an offer by the Debtor to purchase the property for a price which is higher than the appraisals by real estate firms special-

izing in the area. The appraisal procured by the Debtor shows a value of $1,700,000, while that procured by the trustees, at the District Court's request, shows a value of $1,575,000 (R. 42). The Debtor, on the other hand, has offered $1,800,000 for the property. Of this amount, $1,600,000 was to be paid in cash and $200,000 by second mortgage (R. 71). The cash would be supplied from the proceeds of a first mortgage of $1,600,000, for which the debtor has a firm commitment from the Metropolitan Life Insurance Company (R. 78). Thus this proposal represents no vague hope on the part of the Debtor. That it is entitled to consideration[6] appears not only from the fact that the offer exceeds the value indicated by the appraisals in the record, but also from the fact that the trustees accepted, and are still willing to accept, an earlier proposal by the debtor, upon which it was unable to close, to purchase the property for $1,700,000 cash (R. 40–45, 69–73).

The trustees, however, although they once tentatively agreed to the present proposal (R. 70), have refused to submit it to the state court or to certificate holders (R. 73–76), and the state judge refused to entertain a proposal not sponsored by the trustees (see R. 71 and opinions of the majority and minority of the court below, R. 99, 101). The trustees thus refuse to present

[6] We express no opinion whether after use of the investigatory processes of Chapter X a court should approve the Debtor's offer.

to certificate holders or to the state court a plan which appears entitled to consideration. They formally took the position in this case that they alone, not the certificate holders, are entitled to consent to a proposed plan (R. 16).[7]

These circumstances, we submit, show a "need for relief" on the part of the stockholders of the Debtor. They show a proposed plan, entitled on its face to consideration, blocked by the refusal of the trustees to submit it to the state court or to the real parties in interest. Moreover, these circumstances again show that the forum provided by Chapter X is needed not only on behalf of the stockholders, but on behalf of the certificate holders to whom the right to exercise freedom of choice is being denied. *See supra,* p. 6.

In summary, uncontroverted facts, we believe, justify this Court in concluding that there is a need for the relief provided by the administrative and democratic techniques provided by Chapter X, and in reversing the orders below and remanding with directions to approve the petition. At least, the circumstances justify this Court in accepting Judge Clark's view that the case should be reversed and remanded with instructions for trial of the issues (R. 102). These issues were heretofore determined in the District Court without the trial required by Section 144 of the Act (11 U. S. C. Sec. 544).

[7] This contention was rejected by the district judge (R. 82).

CONCLUSION

The writ of certiorari should be granted.

Respectfully submitted,

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